CORONAVIRUS AND SHIPPING OUTLOOK

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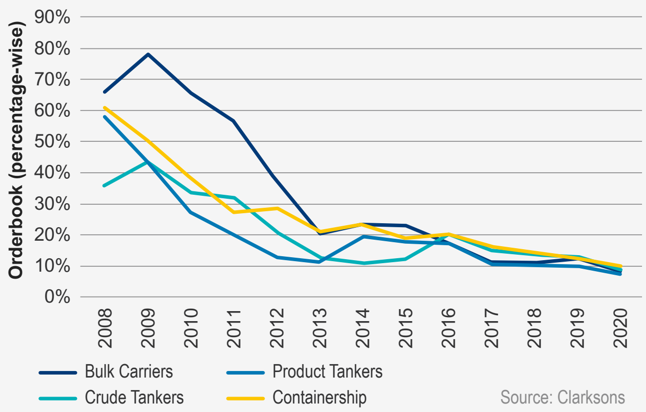
EXECUTIVE SUMMARY

- A slower economic recovery from coronavirus is anticipated outside China, with lingering effects on demand keeping growth below historical trends in the medium-term.
- There have been visible impacts from Covid-19 across all shipping sectors. Whilst tanker owners have enjoyed a period of strong profitability and cashflow, the dry bulk sector faces greater challenges and are experiencing an extremely weak 1H 2020. Container shipping volumes have contracted sharply due to the global lockdown, but decisive action to reduce capacity means that the industry is generally well-prepared to overcome the headwinds.
- Although virus-induced 2020 demand destruction for shipping services is capturing headlines, developments on the supply-side signal longer-term shifts in the industry.
- Orderbook volumes currently stand at historically low levels (percentagewise) across all main shipping sectors, while contracting remains limited, falling by over 60% year-on-year in January-May. On top of increased disruption caused by Covid-19, upcoming environmental regulations are also limiting ordering appetite by creating uncertainty over newbuilding vessel specifications. Covid-19, as well as the environmental agenda, are expected to accelerate the phasing-out of older and less fuel-efficient tonnage.
- Mild fleet capacity growth in the longer-term is fundamentally different from the chronic overcapacity caused by the global financial crisis.

Shipping Orderbooks
Percentage-wise



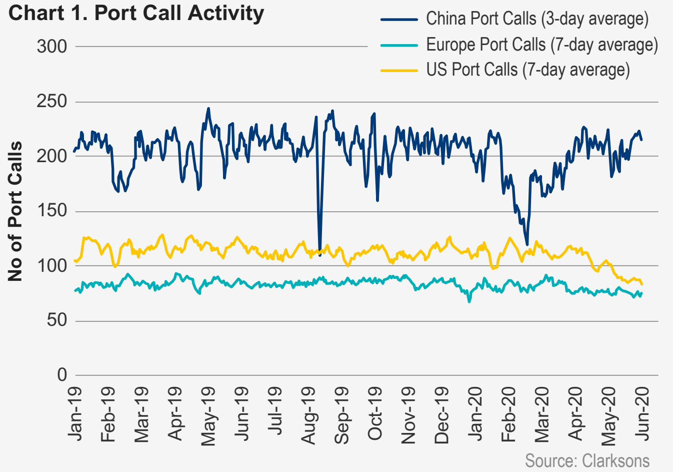
1. MACROECONOMIC CONCLUSIONS

As lockdown measures continue to be eased, attention shifts from the depth of the recession to the shape of the recovery. The recent flow of incoming macroeconomic indicators allows for some tentative conclusions to be drawn. In Europe, the Composite PMI (*aggregate metric of working conditions in both services and manufacturing sectors*) bounced from a survey low of 13.6 in April to 31.9 in May. Despite the significant monthly increase, it is worth remembering that a PMI reading of 50.0 suggests overall business activity was unchanged from the previous month. The 31.9 May reading therefore means that although the peak of European nation-wide lockdowns was April, further noticeable contractions in output of services and manufacturing of products also occurred across the region in May. Covid-19 impact on demand continued, with a lack of new work for companies leading several companies to significantly reduce employment levels. It was a similar story in the US, where the Composite PMI rose from a trough of 27.0 in April to 37.0 in May, but remained significantly below the 50.0 mark which separates contraction from expansion.

In Asia, a mixed picture has emerged. The Caixin China General Manufacturing PMI gained 1.3 index points (m-o-m) to 50.7 in May, bolstered by further increases in output and a pick-up in business confidence. By contrast, Japan, South Korea and the ASEAN (*Southeast Asian nations*) saw an accelerated downturn in manufacturing, albeit at relatively milder rates than in Europe and the US.

A preliminary conclusion is that economic recovery remains very weak outside China, with lingering effects from coronavirus despite the easing of restrictions. The uneven economic recovery is also evident from diverging trends in port call activity ***(see Chart 1)***. Calls in China have risen steadily since March, but have fallen West of Suez.

Chart 1. Port Call Activity

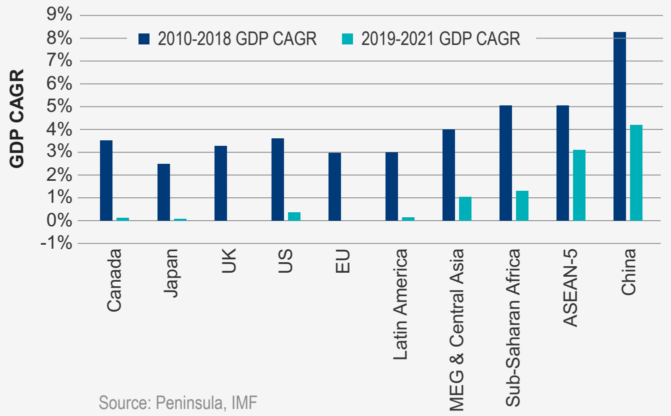


Source: Clarksons

As of early June, new daily reported coronavirus cases were maintaining an upwards trend, making it more likely that some virus-related negative pressure will persist throughout the full year. China is likely to be the only silver lining in the near-term, as evident from a recovery in the country's oil demand in May to almost 95% of pre-virus levels. However, with forward-looking macroeconomic indicators (unemployment, export orders, investment sentiment etc.) elsewhere in the world remaining depressed, production in China will rebound ahead of demand. Reports of surging bank deposits across Europe and the US add to the bearish sentiment, hindering the prospects of a flurry in consumer spending after lockdowns are lifted.

Medium-term, the IMF expects world economic growth to bounce from subdued levels in 2020 to a decade high of 5.8% in 2021, which would mark the largest annual increase on record. However, the low base set this year means that compound annualised GDP growth (CAGR) over the full 2019-2021 period is expected to be much lower than historical trends ***(see Chart 2)***. High infection rates and extensive lockdowns significantly impact economies West of Suez, while Latin America, the Middle East and Sub-Saharan Africa are challenged from falling commodity prices and demand, together with extensive capital outflows.

Chart 2. Economic Trends



Source: Peninsula, IMF

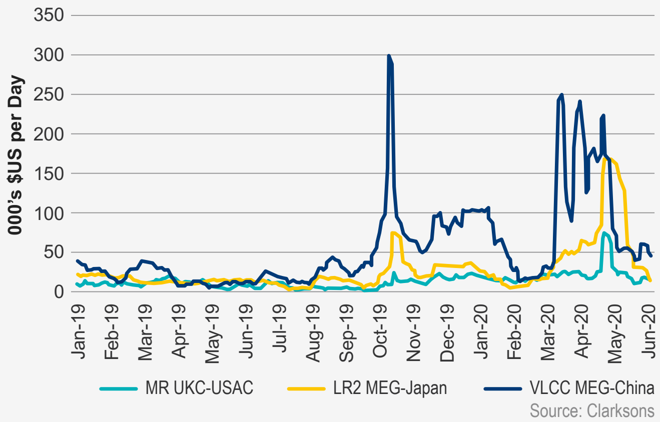
2. SHIPPING SECTOR ANALYSIS

2.1 Tankers

Tanker market trading conditions have been robust since September 2019, providing healthy profitability and cash generation to owners. The most recent spike in tanker rates came in the 2H April, with VLCC earnings surging up to $250,000/day for a trip to China. An LR2 product tanker on the same route reached a historic peak of $170,000/day. Rates were supported by a sudden increase in demand for floating storage, caused by the OPEC+ alliance failing to agree production cuts in March.

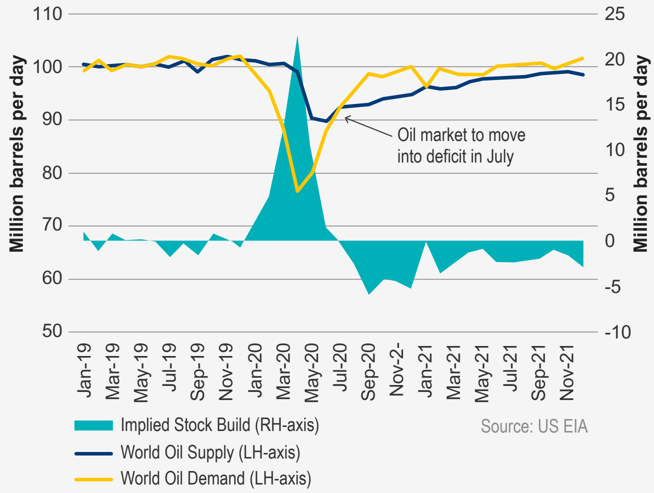
With significant demand destruction caused by Covid-19 lockdowns and increased supply, mainly from Saudi Arabia, the stark mismatch between demand and supply caused a rapid build-up in onshore inventories, with tankers acting as the last resort to place excess oil. An April flurry of VLCC floating storage time-charter fixtures was followed by a jump in product tanker storage plays in the latter half of the month. Boosted by a strong oil market contango structure, peak floating storage absorbed nearly 500 tankers, with significant demand across all sub-sectors.

Chart 3. Tanker Earnings



Sentiment changed moving into May, when implementation of renewed *(and enhanced)* OPEC+ supply cuts weighed on crude cargo availability. The effects of the virus-induced oil demand loss and impacts on refinery throughput gradually permeated the market. Tanker rates softened accordingly, with MEG-China VLCC rates falling to around $50,000/day in early June. Shifting dynamics have accelerated the rebalancing process of the oil market, which is now expected to move from surplus to deficit in July ***(see Chart 4)***. As land stocks begin to draw, some floating storage is expected to unwind, with vessels being added back to the spot market.

Chart 4. Oil Demand/Supply Balance



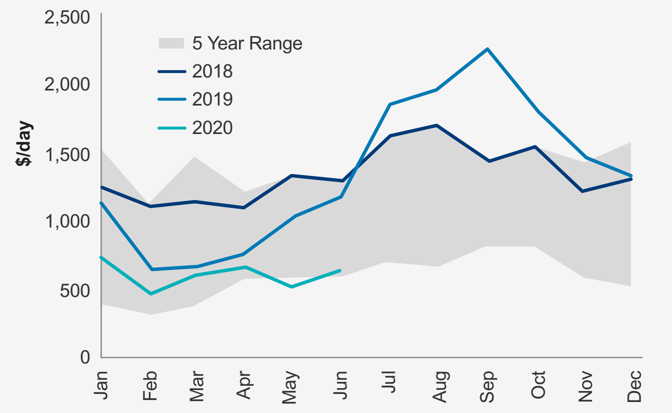
More challenging future tanker market conditions are likely, with an accumulation of products in key regions (ex. ARA jet fuel build-up) expected to pressure product tanker flows. Optimism remains that freight rates will be protected to some extent. Firstly, although floating storage has fallen from its early-May peak, it remains near historically high levels and will continue to occupy a significant number of vessels for the foreseeable future. Furthermore, while refiners globally have scaled back production due to lower demand, Chinese plants are taking advantage of the lower oil price environment to ramp-up imports and output. Notably, China's crude oil imports jumped by 20% year-on-year to an all-time high of around 11.35M b/d in May.

Overall, from an investor's perspective, there is limited upside to the tanker market, as the fundamentally weaker oil demand outside China caps freight rates. Viewing through a bunker supplier credit lens, tanker owners are perceived to be safe following a prolonged period of robust rates. Our base case remains that earnings will not fall below OPEX during 2H2020.

2.2 Dry Bulk

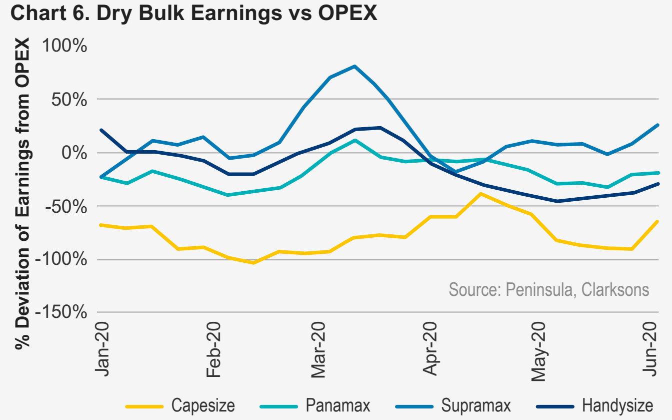
Dry bulk market conditions have been extremely challenging. Despite tentative signs of improvement since mid-May, the BDI remains at uncharacteristically low levels ***(see Chart 5)***. The weak market conditions of April-May came despite expectations of seasonal gains and served to highlight the wide-ranging impact of Covid-19. Pressure on the Capesize sector has been pronounced. Earnings remained more than 50% below OPEX in the year-to-date (see Chart 6). While smaller segments did not reach such low points, earnings have only briefly risen above OPEX, apart from the Supramax sector, which was underpinned by healthy South American grain trade.

Chart 5. BDI Historical Trends



The fundamental issue faced by Capes has not been demand related, as Chinese iron ore imports actually rose 5.1% year-on-year in January-May to over 445M tonnes. Instead, the pressure has largely been due to lower supplies from Brazil, whose exports fell by 9% year-on-year in January-April. The shortfall in Brazilian supplies was met by increased shipments from Australia, where exports were up 11% year-on-year during the same period. This development has caused a build-up of prompt Capesize vessels in the Pacific, with more owners offering their vessels at low rates for short-haul-trips; taking approximately a third of the time needed for a Brazilian cargo to reach China.

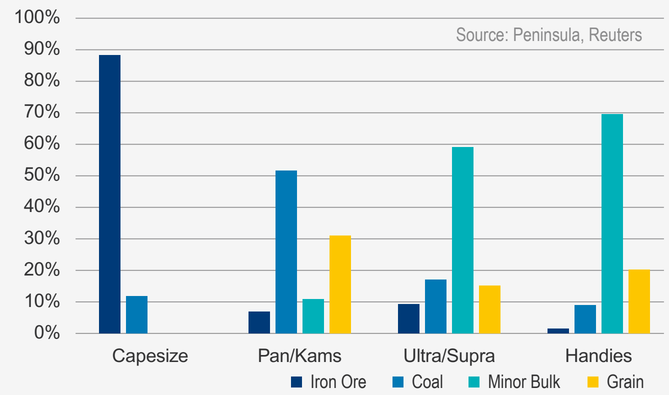
Chart 6. Dry Bulk Earnings vs OPEX



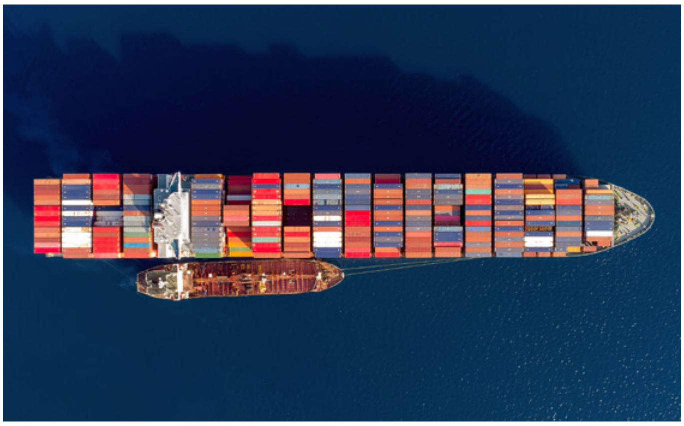
Capesize rates are expected to rise to a more seasonally positive June on the back of Chinese iron ore restocking, with support also coming from substantial government infrastructure projects. Gains are likely to be limited in the short-term, as production issues persist in Brazil. In early June, Vale was ordered to shut down an iron ore complex responsible for more than 10% of its output after several miners tested positive for coronavirus. Furthermore, weak global steel demand *(primary user of iron ore)* presents another hurdle. The World Steel Association estimates that demand outside China will fall by a stark 14.2% year-on-year in 2020.

Smaller bulkers operating West of Suez remain exposed to weaker economic trends ***(see Chart 7)*** and are therefore facing several challenges. Demand for minor bulk commodities such as steel, aluminum or cement remains low due to the adverse effects of Covid-19 in the automotive and construction sectors. In Europe, a key demand centre for metal and mineral minor bulks, the Construction PMI registered 39.5 in May from a record low of 15.1 in April. This serves to highlight the challenge ahead.

Chart 7. Distribution of Cargoes per Bulker Sector



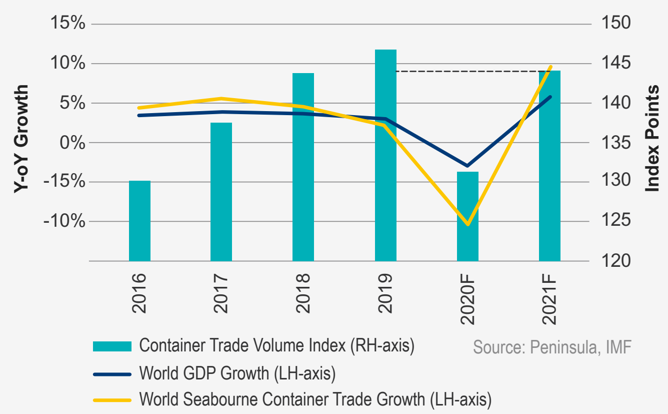
Coal trade will receive near-term support from increased Chinese purchases. Coal stocks at the country's major ports are currently sitting at their lowest levels since 2016. Coal is, however, less dependent on China than iron ore and buying from other major demand regions such as India and Europe has slowed down significantly. The International Energy Agency expects world coal demand to fall by 8% year-on-year in 2020, hampered by lower electricity consumption (steam coal) and reduced manufacturing activity (coking coal). Grain trade has been the primary source of employement for medium-sized bulkers so far this year, but there may be a slower period ahead as the impressive pace of Brazilian long-haul soybean exports eases, while shipments from the US will only pick up towards the end of the 3Q 2020.



2.3 Containerships

The containership sector has been significantly impacted by Covid-19, with global box ship trade volumes forecast to decline by around 10% year-on-year in 2020 *(in TEU terms)*. Underscoring weak demand conditions, retail sales of clothing in the US plunged by 80% year-on-year in April, with sales of electronics and furniture down by 61% and 59% respectively. These are key goods for the containership sector, and the lack of US demand helps to explain the trade slowdown on the mainlane Transpacific route, which is primarily serviced by larger containerships. Prospects of a significant 2H2020 bounce in trade volumes are hindered by lower consumer spending power, high unemployement and financial pressure on the retail clients of shippping companies *(retailing being one of the sectors worst hit by bankruptcies)*. Contraction in demand led to the idle containership fleet reaching an all time high of 2.72M TEU at the end of May. This represents 11.6% of overall fleet capacity, according to data from Alphaliner.

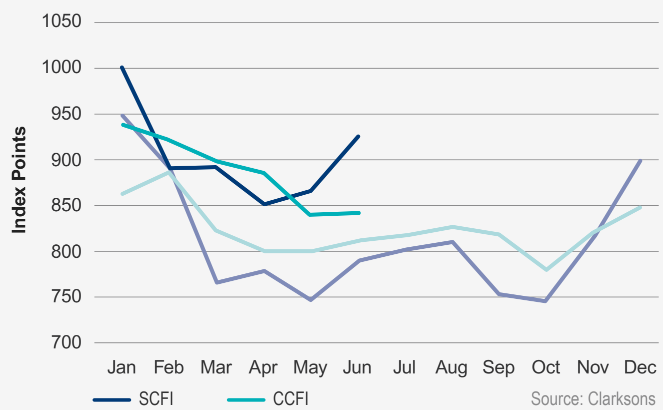
Chart 8. Containership Trade vs World GPD (% Y-o-Y Growth)



On the positive side, several signs suggest that the liner industry has overcome the worst effects of the pandemic. Most notably, carriers have managed to cooperate effectively by coordinating service suspensions and blank sailinigs. Dynamic fleet capacity management has prevented freight rates falling to the levels seen during the 2009 financial crisis. In fact, rates are up y-o-y so far in 2020 ***(see Chart 9)*** and were experiencing further gains in early June. The resilience of freight rates has had a visible impact on the industry's operating results, with several large liners including Maersk, Hapag Lloyd and ONE reporting unexpected increases in 1Q2020 revenues. In simple terms, successful capacity reductions have more than compensated for the volume loss by keeping unit rates high. This has successfully shielded carriers' profitability. Carriers have used other tactics to lower costs, such as avoiding the Suez Canal and transiting around the Cape of Good Hope instead. Higher bunker costs incurred are currently outweighed by avoiding Canal transit fees on the Easterly steam.

On the demand side, there are some encouraging signs that carriers may have overestimated the consumption slowdown in some cases, as evident from recent reinstatements of previously blanked sailings. Overall, although no significant hike in trade volumes are expected in 3Q 2020, the trough in trade volumes is likely to be in June-July, with potential for a recovery from 4Q 2020.

Chart 9. Containership Freight Rates



It is worth noting that even in the midst of the 2009 financial crisis, no large carrier went bankrupt. The industry is now better prepared to mount an effective response, following two decades of consolidation that saw the market share of the top 10 liners *(in terms of TEU capacity)* increase by roughly 35% to over 85%. Large carriers are expected to keep raising their share in a post-pandemic world, with smaller carriers likely to face the greatest financial pressure. Consolidation and supply chain integration are two trends we see likely to continue in the liner market.

Contact us for further information

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